Wealth Management
Dominion Securities

2022 Q4 commentary

Jon Mitchell, Portfolio Manager

Jon Mitchell
Portfolio Manager &
Investment Advisor
jon.mitchell@rbc.com
Phone: 780-944-8851
Fax: 780-424-7153

Broken lines, broken strings,
Broken threads, broken springs,
Broken idols, broken heads,
People sleeping in broken beds
Ain't no use jiving
Ain't no use joking
Everything is broken

Broken bottles, broken plates,
Broken switches, broken gates,
Broken dishes, broken parts,
Streets are filled with broken hearts
Broken words never meant to be spoken,
Everything is broken

Seem like every time you stop and turn around
Something else just hit the ground

Broken cutters, broken saws,
Broken buckles, broken laws,
Broken bodies, broken bones,
Broken voices on broken phones
Take a deep breath, feel like you're chokin',
Everything is broken
Every time you leave and go off someplace
Things fall to pieces in my face

Broken hands on broken ploughs,
Broken treaties, broken vows,
Broken pipes, broken tools,
People bending broken rules
Hound dog howling, bull frog croaking,
Everything is broken

"Everything is Broken," written by Bob Dylan, released in 1989 on his **Oh Mercy** album.

Everything is broken

A survey of the news headlines over the last six months paints a fairly glum picture. To name just a few stories from memory: Civil servants demanding 40% pay increases and threatening strike action, federal and provincial governments at odds over energy policies and control of resources, hospitals being forced to close departments due to staff shortages, the highest rise in food prices in decades, a war (effectively between two nuclear superpowers) that seems entrenched to last for some time, CSIS leaks of alleged interference by China in the 2019 and 2021 federal elections and, most recently, the failure of three U.S. banks.

With these issues in mind, what is going to be the next move? You may have watched The Queen's Gambit on Netflix when it came out in late 2020, depicting the rise of a young, American chess prodigy. The main character, Beth Harmon, grew up in an orphanage in the 1950s, then rises from obscurity to eventually compete in the world championship against the Russian world champion, Vasily Borgov. Unlike life, where many decisions seem to be made in real time in a reaction to the latest news, chess masters are routinely planning 10 moves ahead, and some are reputed to be able to see anywhere from 15 to 20 moves ahead. Trying to glean some wisdom from the chess masters for our own lives, we could lay out a number of suggestions for personal life moves, including:

- Try and filter out or turn off the "noise" that tends to distract us and stifle our focus.
- Strive to put your energy into things you have some degree of control over, including your health, diet, exercise, companionship and spending lots of time with friends, family, and even our pets.
- Stimulate your mind through reading books and articles, listening to podcasts

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or music, and challenging others by debating the issues going on in your lives. In other words, become a critical thinker.

- Downplay our "wants" and focus on the basic needs of life.
- Look at the longer term in a positive manner, by referencing the struggles and challenges that you have been through in your own lifetime and somehow managed to survive and learn from.
- Mentor the next generation(s). We all learn more from our failures than we do from our temporary successes. Helping others avoid the mistakes we made could go a long way to improving their outlook.

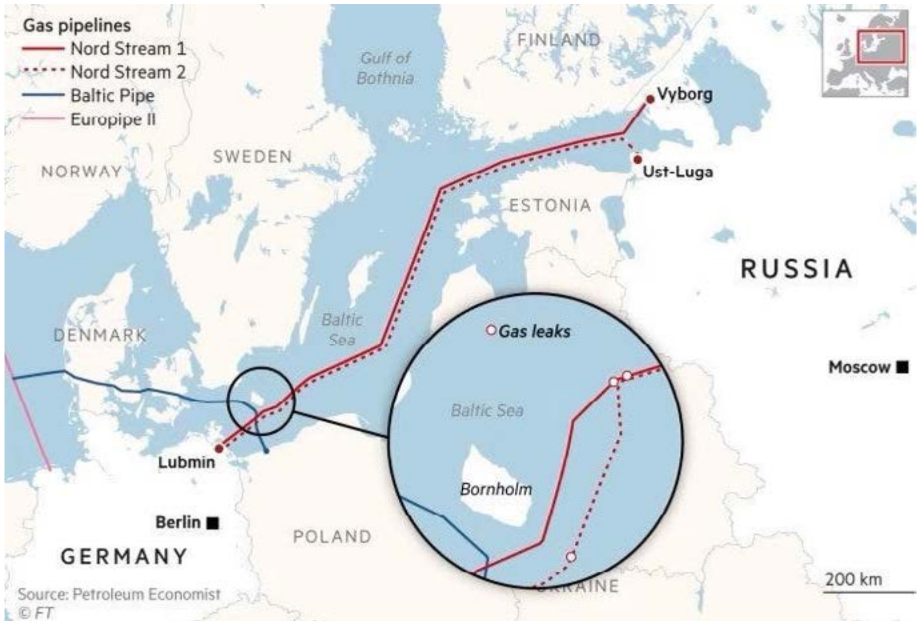
Ukraine – Russia War

About 20% of the Ukrainian population, or just over eight million citizens, have left the country since the start of the conflict last February.[1] The battles increasingly involve massive artillery launches, which are leveling buildings, homes, fields and roads. This video link is from a few months ago,[2] and the area in question (Bakhmut) remains the most intense area of the fighting, with thousands of lives being lost on both sides.[3] To be clear, verifying casualties is very difficult and exaggerating losses of the enemy is an essential part of the fog of war. In 2022, the U.S. congress appropriated more than US$112 billion for Ukraine, with about US$46 billion for military arms and equipment.[4]

There seem to be no plans for a cease fire, despite a 12-point position paper released by China on February 24, 2023.[5] The West reacted the proposal with skepticism – NATO stating that Beijing did not have much credibility as a mediator.[6]

Nord Stream 1 and 2 sabotage: The plot thickens

As I shared in my last commentary, on September 26, 2022, there was a major escalation in the war beyond the borders of Ukraine as two natural gas pipelines that traverse the Baltic Sea between Russia and Germany were sabotaged by undersea explosive. As I had noted before, there was no party or country that acknowledged that the sabotage was their doing, with both sides accusing the other of blowing up the two natural gas pipelines.



Source: Financial Times Maps

However, on February 8, 2023, the 85-year-old U.S. investigative journalist Seymour Hersh, published a detailed piece that claimed that the Biden Whitehouse began planning back in late 2021 and into the early months of 2022 to destroy the pipelines using a team of U.S. Navy deep-sea divers. Hersh claimed they had the assistance of the Norwegian Navy, who annually participated in a NATO exercise in the Baltic Sea involving scores of allied ships.7 Hersh alleged that the C4 explosives were attached by the dive team in June just off of Bornholm Island at a depth of 260 feet, with the delayed timing devices triggered by a sonar buoy. The buoy was allegedly dropped by a Norwegian Navy P8 surveillance plane on a routine flight on September 26, and a few hours later, three of the four pipelines were put out of commission.[7]

The problem with Hersh's Substack piece is that the whole article relies on only one unnamed source, and the U.S. Whitehouse has categorically denied the entire article.[8]

Why Hersh, a five-time winner of the prestigious George Polk Award in Journalism would stake his career on this article may give you some degree of confidence in its veracity. His most famous pieces included the uncovering of the My Lai Vietnam Massacre in 1959 and the U.S. Marine abuse at the Abu Ghraid prison in 2004. Moreover, if Hersch's position is true, then the Biden Administration has willingly undertaken an act of war without the endorsement of the U.S. Congress against both Russia and Germany, the joint owners of the pipelines. It should be noted, however, that Hersch's later work has been controversial and widely criticized by journalists for promoting conspiratorial claims that verge on speculation.[9]

Five days after German Chancellor Olaf Schulz met with President Biden in Washington, DC, to discuss the latest developments in the Ukraine-Russia war, on March 8, 2023, The New York Times and The Wall Street Journal published short articles indicating that U.S. officials were investigating the possibility of a "pro-Ukrainian group" being responsible for the attack on the Nord Stream natural gas pipeline.10 These articles stated that "neither Russian-government nor pro-Russian operatives were behind the sabotage." Ukraine was swift to deny that they had no reason to carry out such an attack because "it didn't advance any of Ukraine's core interests."[10]

In a later WSJ article published the next day, the boat was identified as a sport sailing boat that was rented by six people, some of who presented Ukrainian passports as identification and navigated to the specific location despite the massive naval exercises that were under way.[11] In neither article was Hersh's lengthy expose referenced.

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Pandemic update: China ends Zero COVID-19 policy

In many respects, by the middle of 2022, most Americans, Canadians and Europeans had returned to their pre-pandemic lives. If you were a resident of China, however, where the virus purportedly originated from, many areas of that country had been subjected to rolling lockdowns throughout 2022 into early December 2023. Foreign travellers had effectively been banned since March 2020, some neighbourhoods were restricted, and people who tested positive were forced to go to quarantine camps. Eventually, a segment of the Chinese population started resisting these harsh measures and a number of protests occurred between November 24 and November 26.[12]

Some of the videos shared by Western news media included one of a burning apartment building that allegedly had door and exits blocked due to lockdown measures, which resulted in casualties from the fire. (Beijing denied these accusations.) This may have been the tipping point that prompted the Chinese authorities to begin to ease some of their restrictions, which had been seeking to restrict movements until no positive cases were evident for a period of time.[12]

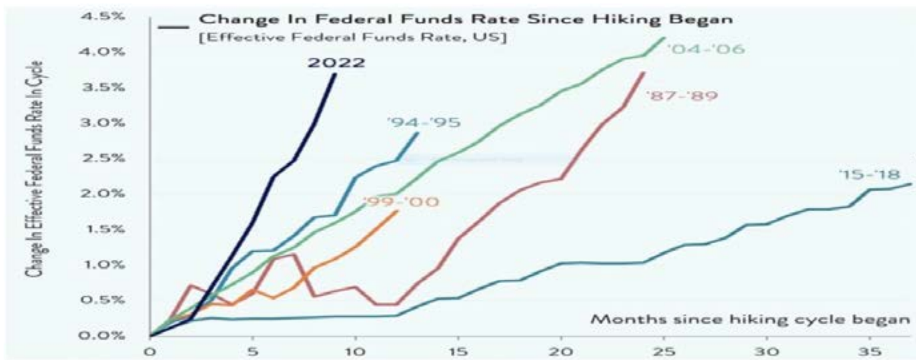
By January 8, 2023, China announced that they were scrapping quarantine for travellers, re-opening the country with work and study visas or those seeking to visit family.[13] On March 15, 2023, China re-opened its borders to tourists and resumed issuing all visas.[14]

Here in Alberta, Premier Danielle Smith, has appointed the Public Health Emergencies Governance Review Panel, chaired by former Reform Party founder, Preston Manning, to review the legislation that guided Alberta's response to COVID-19.15 The panel will recommend changes to improve the handling of future emergencies for Albertans.[15] It will also consider and appropriately balance the following factors in the overall context of a public health emergency:

- General public health and health information, mental health and wellness, child and student health, mental health and education, health professionals' practice standards, effective implementation of emergency measure, protection of rights and freedoms, economic and financial effects, and employment standards.[15]

Investment observations

Overall, 2022 went down as one of the worst years for nearly every investment option for several decades. As I noted in my previous commentary, 2022 was the worst year on record for U.S. Treasury bond returns with losses in excess of 13%. The speed at which rates have increased in 2022 has caused carnage in the debt universe as prices had to be marked down significantly to reflect the fact that five-year bond rates went from 1.26% on January 1, 2022, to 3.06% on December 31, 2022, and as high as 3.66% on March 3, 2022. Indeed, when you look at other periods where the central banks were tightening monetary policy by raising short term interest rates, this is the fastest move in recent history.

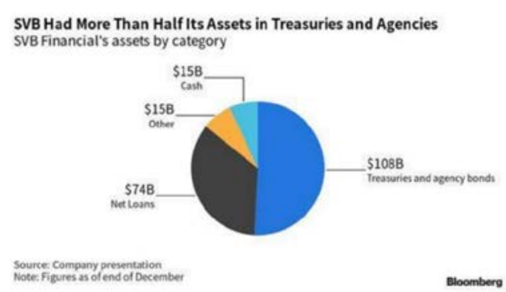


Source: Federal Reserve

SVB failure: Symptomatic of complacency for rising rates

A large number of buyers of government bonds are banks, as this is a normal and secure investment with which to offset their deposits, and the U.S. government has more favourable terms for collateral with these securities. However, when a bank buys a five-, 10-, or even 30-year government bond, although they are not taking any default risk (as the government bond is rated AAA), they are taking on interest rate risk that rates may increase, and that the value of the bond must temporarily decline in value to reflect the higher rates now in place.

This is essentially the situation that predicated the recent failure of three U.S. banks in March, the largest being the Silicon Valley Bank (SVB) based in Santa Clara, California.



Most of SVB's customers were in the technology sector, with many new start-up firms that had raised a significant amount of capital in 2020 and 2021 while interest rates were very low. With one-year government bond rates approaching 5%, the ability of these firms to raise new capital has been much more difficult given the opportunity cost that exists in bonds. Moreover, with the steep increase in short-term deposit rates (see graph below), depositors were able to access far higher interest rates by buying short-dated Treasury Bills than holding certificate of deposits (CDs) at SVB. Many technology start-up firms are generally unprofitable in their early years, and they were requiring their deposits to fund their operations.

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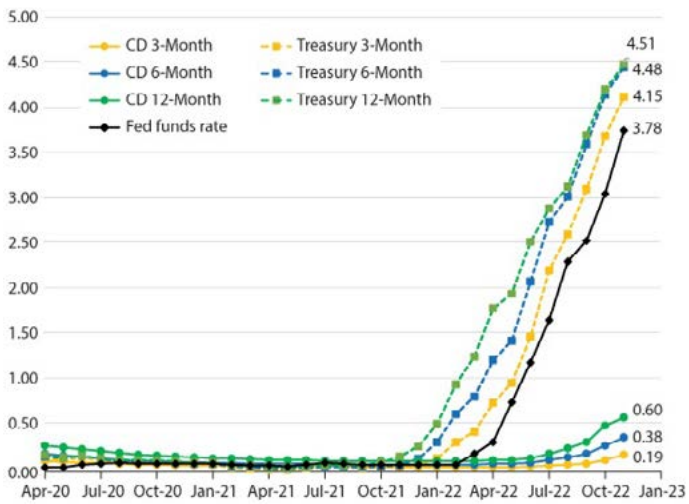
As a result of all of these factors, SVB was forced to sell some of its U.S. government bond portfolio to meet the demands of the withdrawals. This sale locked in the losses that resulted from the swift increase in interest rates from when the bonds were purchased – when rates were in the low 1% range. At the end of 2022, they had reported a mark to market or unrealized loss on their securities held to maturity of more than US$15 billion (versus only US$16 billion of equity). The bar chart above shows the unrealized losses on all investment securities for institutions regulated by the Federal Deposit Insurance Corporation (FDIC) at more than US$650 billion at the end of 2022. This indicates that although SVB was a bank that did fail, there are scores of other U.S. banks in the same situation with significant unrealized losses on their investments.

The Fed rides to the rescue with the BTFP

Over the weekend of March 12, 2023, and in light of the seizure of SVB and Signature Bank, the U.S. Federal Reserve (the Fed) announced two extraordinary measures: First, the Fed announced that it would guarantee 100% of ALL deposits at these banks, both the US$250,000 FDIC-insured deposits and all uninsured deposits in excess of that amount. This certainly saved hundreds of businesses from failure as most had out-sized uninsured deposits at SVB. The move was also done to instill confidence in the banking system and to discourage customers from moving their deposits from the smaller regional / local banks to the large money centre banks.[16]

The second announcement was the establishment of the Bank Term Funding Program. Under this program, banks, savings associations, credit unions and other eligible depository institutions may pledge collateral of eligible securities (largely U.S. Treasury and federally insured mortgages) at their par value, and receive cash in return. For example, a 10-year U.S. Treasury Bond issued in February 2021 (due to mature in February 2031) is currently priced at $85 (face value is $100), so the U.S. Federal Reserve program would loan the bank $100 of cash, and take the February 2031 Treasury Bond as collateral for the loan. This program is designed to provide liquidity to the banking sector to meet any excess customer withdrawals. JP Morgan estimates that as much as US$2 trillion of funds could be put into the U.S. banking system through this program.

CD and T-bill Rates (Apr 2020-Nov 2022)



NOTE: The certificate of deposit (CD) rates are for current quotes by institutions and thus represent new rates—not rates on existing deposits. They are for CDs with a minimum of $10,000. Data cover interest rates quoted by more than 96,000 banks and savings and loan institutions.

SOURCE: U.S. Treasury Bills (T-bills) and federal funds rate from the H.15 Board of Governors (retrieved from FRED®); CD data from Ratewatch (retrieved from Haver).

If this holds to be the amount accessed, it could swell the U.S. Federal Reserve's balance sheet to more than US$10 trillion, which could exacerbate the already sticky inflation levels.[16]

As set out below, apart from holding U.S. dollars and a basket of commodities (anchored by energy commodities), all other investment classes ended the quarter down double digits. As discussed earlier, the most significant change in the past year was the steep increase in interest rates, which were fueled by the highest inflation figures since the 1980s. This has prompted many investors to shift funds from their bank accounts into short term deposits and Guaranteed Investment Certificates (GICs), which hit their highest levels since 2008 in November 2022.

TOTAL RETURNS (%)

Through Dec. 31, 2022. Asset classes ranked by 1 month % total return

Asset Class (ETF ticker)	1 mo	YTD	3 yr▪	5 yr▪
Foreign Junk Bonds (IHY)	1.2	-14.3	-3.3	-0.5
Emg Mkt Gov't Bonds (EMLC)	0.9	-10.6	-5.9	-3.3
Cash (SHV)	0.4	0.9	0.5	1.1
Foreign Devlp'd Mkt Gov't Bonds (BWX)	-0.2	-19.7	-7.1	-3.5
US Bonds (BND)	-0.8	-13.1	-2.8	0.0
Foreign Corporate Bonds (PICB)	-1.0	-22.6	-6.7	-3.6
TIPS (TIP)	-1.3	-12.2	0.9	1.9
Commodities (GSG)	-1.7	24.1	9.4	5.5
Foreign Real Estate/REITs (VNQI)	-1.7	-22.9	-8.9	-3.6
US Junk Bonds (JNK)	-1.9	-12.2	-1.4	1.3
Foreign Devlp'd Mkt Stocks (VEA)	-2.2	-15.4	1.2	1.6
Emg Mkt Stocks (VWO)	-2.2	-18.0	-1.5	-0.2
Foreign Inflation-Linked Gov't Bonds (WIP)	-2.5	-15.6	-4.3	-2.1
US REITs (VNQ)	-5.0	-26.2	-0.4	3.7
US Stocks (VTI)	-5.8	-19.5	7.0	8.6
Global Market Index†	-3.8	-17.8	2.4	4.0
S&P 500 (SPY)	-5.8	-18.2	7.6	9.2
Crude Oil (USO)	-0.2	29.0	-11.9	-6.0
Gold (GLD)	2.9	-0.8	5.9	6.7
US Dollar Index (UUP)	-1.9	9.5	2.6	3.7

▪ annualized § based on trailing 252-trading-day return

† GMI is a passive, unmanaged, market-value weighted index of all the major global asset classes (excluding cash).

Data: Tiingo.com

CapitalSpectator.com

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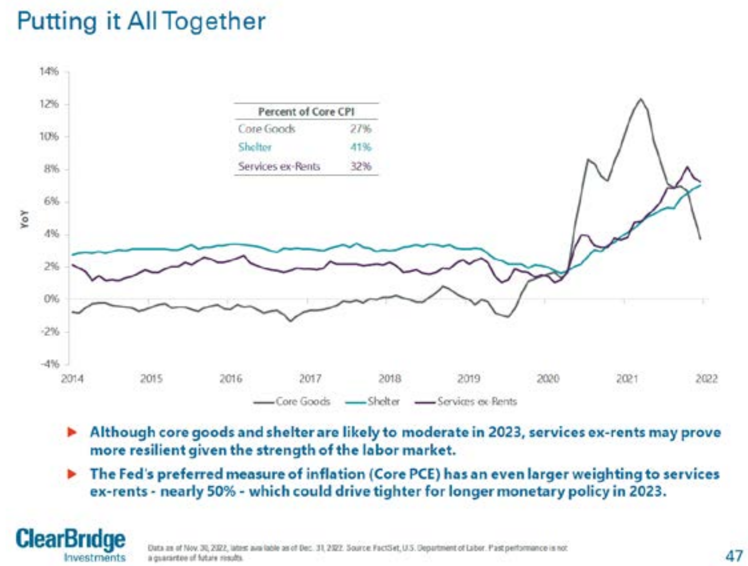
Inflation: Services becoming the major influencer

As you can see, both shelter and services (ex-rents) have been steadily rising since the middle of 2020, with both reflecting about a 6% year-over-year increase. As costs increase for households, the demand for higher wages also increases. The second chart illustrates how wages have moved higher in 2021 and 2022 while companies are finding it more difficult to raise prices. This could put pressure on earnings margins. These two charts are courtesy of Nathan Ma from Franklin Templeton.

Our "Featured Guest Commentary" this time comes from Sandy Liang at Purpose Investments, who runs their Credit Opportunities Fund. He noted in his most recent piece that: "Recently, investors have been reminded that the U.S. economy is still in the lag period between higher interest rates through 2022 and their subsequent effects – Milton Friedman (famous economist) has characterized these lags as 'long and variable.' Most recently, the abrupt failure of SVB due to mismanagement of the asset side of the balance sheet (and associated bond losses) is a reminder that it's difficult to forecast where higher interest rates will 'break something' and result in corporate failures. We view this action (guaranteeing ALL deposits both insured and uninsured) as similar to the Fed engineering the Bear Stearns acquisition by JP Morgan in 2008, where the first $30 billion of losses due to the Bear Stearns assets were borne by the U.S. taxpayer to quell systematic financial risk."

Here are a few charts that I clipped in the past few months that illustrate some of the market issues and changing trends. The first one reflects the remaining Bank of Canada and U.S. Federal Reserve meetings this year. For Canada, the market is forecasting no more interest rate hikes, and two potential 0.25% cuts in Q2 and Q3. For the U.S., one more 0.25% increase is forecast for March, followed by two potential 0.25% cuts by the end of the year. Inflation data will be a key determinant, along with employment levels and general economic conditions.



Current Implied Government Overnight Rates

Canada			US		
Meeting	Implied Rate	#Hikes	Meeting	Implied Rate	#Hikes
04/12/2023	4.45	-0.16	03/22/2023	4.75	0.69
06/07/2023	4.28	-0.84	05/03/2023	4.89	1.25
07/12/2023	4.09	-1.58	06/14/2023	4.77	0.76
09/06/2023	4.02	-1.87	07/26/2023	4.52	-0.24
10/25/2023	3.96	-2.11	09/20/2023	4.35	-0.92
12/06/2023	4.00	-1.95	11/01/2023	4.24	-1.37
Target:	**4.50**		Target:	**4.75**	
Effective:	4.50		Effective:	4.58	

Source: Bloomberg

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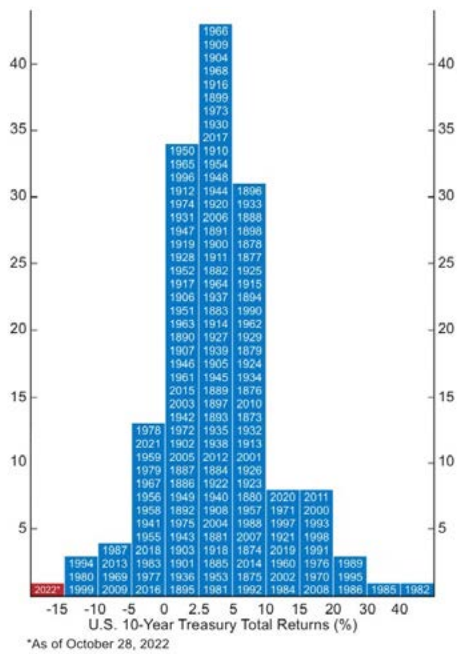
The last bar chart really emphasizes the severity of the losses incurred in what is traditionally known as a fairly stable and staid investment (U.S. 10 Year Treasury Bond). The outsized 2022 losses are the worst in modern history, which contributed in large part to what happened this month with the SVB and Signature Bank, as noted earlier.



Notable quotes

"In the councils of government, we must guard against the acquisition of unwarranted influence, whether sought or unsought, by the military industrial complex. The potential for the disastrous rise of misplaced power exists and will persist. We must never let the weight of this combination endanger our liberties or democratic processes. We should take nothing for granted. Only an alert and knowledgeable citizenry can compel the proper meshing of the huge industrial and military machinery of defense with our peaceful methods and goals, so that security and liberty may prosper together."

– President Dwight Eisenhower's farewell address to the nation on January 17, 1961.[17]

"The reason inflation was brought down to manageable levels by the time of Ronald Reagan's re-election, was directly attributable to Jimmy Carter's very courageous act. Hiring a Federal Reserve chair with the charge to induce a recession. That recession was probably the reason he did not win a second term."

– Rick Perlstein, U.S. journalist and historian

Books I've recently finished reading will return shortly.

Team updates

- Here in Alberta, our work arrangements are four days in office / one day work from home. Either Pauline or James are here each day, though. It has been good to see clients face-to-face for office meetings again.
- The ski season for Jon is moving into the spring, while Monday night RBC Hockey finished up its year with another successful stint. He is hoping to get out to Saskatchewan to check in on the spring seeding in early May.
- Pauline continues to work on her 2023 Pysanka artworks, and hosted several workshops this year.
- James and Nicole are planning a multi-stop trip to Japan in May.
- Finally, we would like to recommend that you circle back to our website from time to time, as we are using that as one of our primary points of contact to post salient articles on our firm's views, along with details on relevant government programs and announcements. You can access it here: ca.rbcwealthmanagement.com/jon.mitchell/

Again, stay safe and take care. We have a lot to be thankful for, living in Canada. Do your best to enjoy the positive moments each day, and please support your local businesses whenever you can.

Sector performance

Below is a table of the performance of various sectors for the 2022 Q4 results / Year-to-Date and three-year rolling periods.

Investment index	Q4 2022 return	Year to Date 2022 return	3-year compound return
S&P/ TSX composite index	6.0 %	-5.8 %	7.5 %
S&P 500 (C$)	5.4 %	-12.2 %	9.2 %
NASDAQ Comp (C$)	-3.0 %	-28.3 %	6.8 %
Short-term comp bond index	0.8 %	-3.9 %	0.1 %
iShares U.S. High Yield Bond Index ETF (XHY, C$ Hedged)	4.1 %	-11.50%	-1.8 %
US$ / C$	-2.0 %	7.2 %	1.4 %
Gold bullion (C$)	7.5 %	7.1 %	7.6 %
Global gold mining index (XGD – C$)	15.3 %	-3.0 %	3.4 %
iShares Energy Index (XEG – C$)	14.1 %	53.2 %	22.6 %

Source: RBC Capital Markets Quantitative Research, Benchmarks, Monthly – December 2022, January 3, 2023.

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